Nepal

Growth slowed in FY2011 on weaker remittance inflows, a downdraft in real estate, fuel and power shortages, and continued political uncertainty. Inflation stayed hovering around the double-digit threshold, and the banking system came under stress. The outlook is for a modest pickup in growth but with some progress in bringing down inflation. Timely completion of the peace process, including an agreement on a federal structure and on a new constitution, would allow political leaders to focus on spurring growth and development.

Economic performance

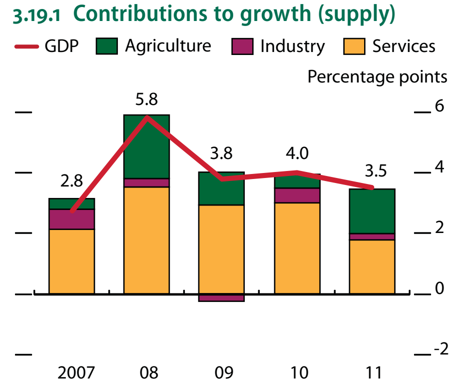
Economic growth dipped to 3.5% in FY2011 (ended 15 July 2011), restrained by slower growth in the worker remittances that underpin consumer spending, a deep correction in the real estate market, and continued political uncertainties (Figure 3.19.1). Expansion in services slowed sharply on hesitant consumer spending and a marked decline in tourism receipts. Industrial growth fell by half, reflecting severe fuel and electricity shortages, weak construction, and the closure of several manufacturing plants owing to labor–management disputes. Favorable weather allowed agricultural output to rebound, but the gain was too little to prevent overall GDP growth from slowing.

Inflation was high in FY2009–2011, broadly mirroring price developments in India, with which Nepal has a pegged exchange rate arrangement and tight trade links (Figure 3.19.2). Escalating food prices were the main driver in the first half of the year and, as these moderated in the second half, nonfood prices picked up, partly because of increases in fuel prices by the Nepal Oil Corporation, the state-owned monopoly supplier. Prices were adjusted several times (political pressure reversed two of the increases), but were inadequate to prevent either a buildup of arrears with the India Oil Corporation or supply disruptions, which led to frequent fuel shortages and transport strikes.

The budget deficit widened from 1.9% to 2.4% of GDP in FY2011: capital spending picked up, marking the government's moves to improve project implementation, and revenue fell short of target. Revenue collection as a share of GDP fell for a second year, mainly because of sharply weaker growth of customs receipts and value-added tax (VAT) (Figure 3.19.3), damped by stagnant non-oil imports and slow growth in private consumption (a key source of VAT). The deficit was financed mainly by borrowing from banks.

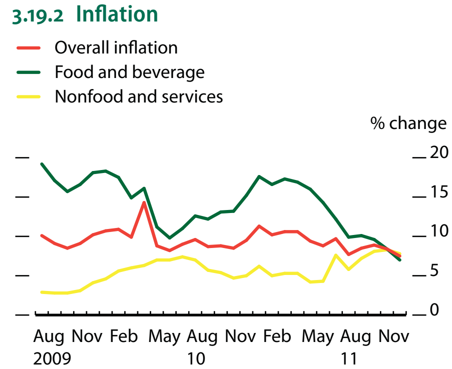
Nepal Rastra Bank, the central bank, focused much of its effort in FY2011 on managing vulnerabilities in the financial sector. In recent years a growing number of small financial institutions have aggressively

3.19.1 Contributions to growth (supply)



Source: Ministry of Finance. 2012. *Mid-term Review of the FY2011-12 Budget*.

3.19.2 Inflation



Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

This chapter was written by Yubraj Acharya and Neelina Nakarmi of the Nepal Resident Mission, ADB, Kathmandu.

attracted deposits from commercial banks to expand their lending, especially for real estate. As market prices of property have fallen heavily, the share of nonperforming loans has increased throughout the financial system, and several small institutions required emergency assistance. Balance-sheet problems at banks coupled with too few attractive lending opportunities ensured slow growth in credit to the private sector, despite abundant bank liquidity that pushed the interbank rate down (Figure 3.19.4).

With about half the banking system's credit collateralized by property, the central bank is encouraging bank consolidation through incentives (it has approved six merger deals and is reviewing another six) and intends to use other measures to assist banks through a troublesome period.

The current account deficit slimmed to 0.9% of GDP in FY2011 after widening to 2.7% of GDP a year earlier. Exports, having declined in FY2010, grew by 11.7%, thanks to a rebound in the growth of traditional exports such as carpets and pashmina (Figure 3.19.5), items that mainly go to countries other than India.

Apart from the slower worker remittances—possibly affected by the unsettled times in the main employment destination of the Middle East—a key hindrance to greater improvement in the current account was the higher oil import bill, as non-oil imports were essentially unchanged from a year earlier. The Nepal Tourism Year 2011 campaign did attract tourists over and above the usual numbers, but as most were budget tourists from neighboring countries earnings fell by nearly 10% from a year earlier.

Net capital inflows more than covered the current deficit and official foreign exchange reserves increased to $3.0 billion, equivalent to 5.8 months of imports (Figure 3.19.6).

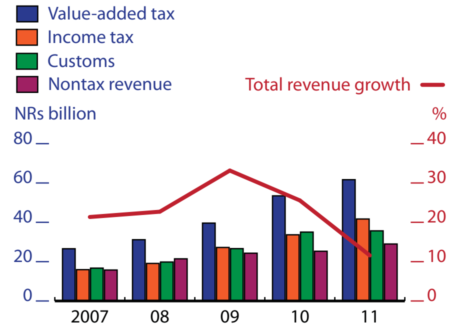
Economic prospects

Economic performance in the forecast period depends primarily on how the political situation evolves. Timely completion of the peace process, including a draft of the constitution ready by the 31 May deadline, will help spur growth, but will require an agreement on federal restructuring—one of the main contentious issues in the peace process. Such closure could allow political leaders to refocus on the economic agenda, paving the way for measures ushering in much-needed private participation in development, boosting business confidence, and improving labor relations. It would also allow them to pursue policies in the Immediate Action Plan for Economic Development and Prosperity, announced in January 2012.

Assuming that the peace process shows success—and that the weather is normal—GDP is projected to grow by 4.5% in FY2012. The improvement from a year earlier will come from faster growth in agriculture and services. Strengthening remittances and rebounding tourism earnings (foreshadowed in the early months of the fiscal year) will buttress services. Industry is notable by its absence as a growth driver: with no improvement expected in power supply, its performance will remain sluggish.

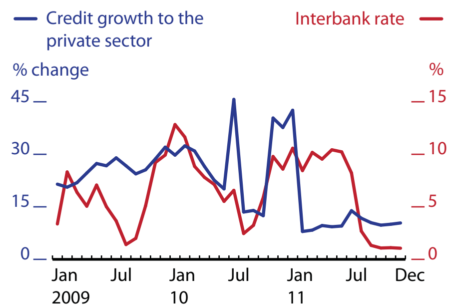
GDP growth will slow to 4.0% in FY2013, around the speed limit for an economy inhibited by long-standing structural bottlenecks and policy

3.19.3 Revenue indicators



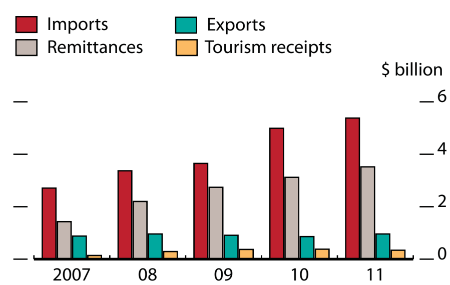
Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

3.19.4 Credit to private sector and interbank rate



Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np distortions that can be addressed only gradually. Agriculture's expansion in FY2011 and FY2012 reflects a recovery (from earlier poor weather) that provided a fillip to growth in the sector and to GDP, but that upturn masks deep-seated problems in raising low productivity and growth to the sector's higher potential.

Inflation gently declined in the first half of FY2012, pointing to an annual average of 8.0%. Food inflation is benefiting from better harvests as well as mitigated global price pressures. The high base effect of the previous year and supportive monetary policies will also keep price rises down. Despite pressures from needed upward revisions in fuel prices, inflation is expected to ease to 7.0% in FY2013, broadly in line with India's.

On the monetary side, the central bank will maintain its focus on encouraging financial sector consolidation, reforming poorly performing banks, enhancing financial inclusion, and strengthening its own supervisory capacity. Managing commercial banks' liquidity will remain tricky, given the need to strike a balance between containing inflation and supporting growth (for the latter, the central bank has directed commercial banks to increase lending to agriculture and energy).

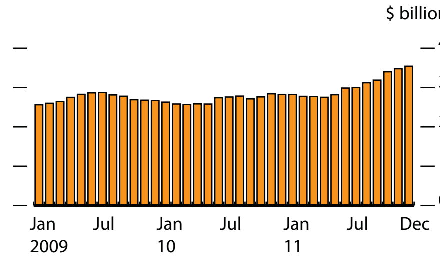
The trade deficit will widen over the next 2 years, with faster growth in imports than exports spurred by sustained high oil prices, and by a rise in non-oil imports. Yet the current account is projected to move to a surplus of 0.5% of GDP in FY2012 and to 1.0% of GDP in FY2013 owing to stronger remittances and tourism receipts. Remittances will accelerate because of the high number of out-migrants in FY2011 and wage increments in destination countries; tourism receipts are on the rise, apparently reflecting the delayed impact of the Visit Nepal Year 2011 campaign.

The FY2012 budget, which was announced on time for the first time since the Constituent Assembly elections in 2008, targeted growth in revenue and expenditure of 19% and 25%, respectively, compared with the estimated amounts in FY2011 (Figure 3.19.7). Though ambitious, if these targets are met, they would create a domestic borrowing need of about 2% of GDP—reflecting the government's continued commitment to fiscal prudence.

Yet the government still faces an uphill task in fiscal management. Recent years have seen the budget increasingly stretched by subsidies, in particular to public enterprises. Such payments in FY2012 are put at about one-fifth of budget expenditure, and rolling them back in a politically charged environment will be hard. Building the physical infrastructure and human resources for the envisaged federal structure will also require heavy spending.

The government needs to end such subsidies, and create a fiscal cushion, including bringing the informal sector into the formal tax base. In addition, expanding the tax base is necessary to reduce dependence on foreign aid, which finances about three-fifths of government capital spending. Public external debt as a share of GDP has stabilized in recent years primarily because the World Bank and ADB (the two largest donors) have been providing a significant share of their contribution in the form of grants, but at more than one-third of GDP, it warrants prudent debt management.

3.19.6 Gross international reserves



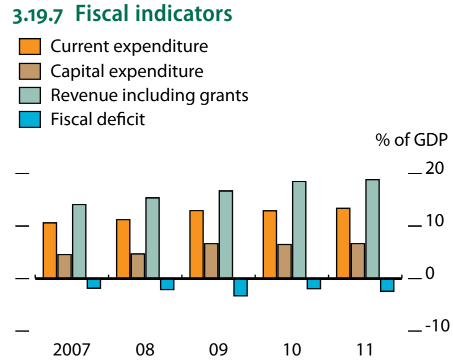
Source: Nepal Rastra Bank. 2012. *Recent Macroeconomic Situation*. http://www.nrb.org.np

3.19.1 Selected economic indicators (%)

	2012	2013
GDP growth	4.5	4.0
Inflation	8.0	7.0
Current account balance (share of GDP)	0.5	1.0

Source: ADB estimates.

3.19.7 Fiscal indicators



Source: Asian Development Outlook database.

Policy challenge—politically induced market distortions

In recent years, the economy has suffered from several market distortions, originating mainly in the fragile political environment and compounded by poor law enforcement (Table 3.19.2). These distortions—seen most clearly in electricity theft and technical leakages (estimated at 29% of total output), business cartels, fuel hoarding and frequent shortages, and transport syndicates—are responsible for keeping prices high and for exacerbating the already-poor investment climate.

Fuel shortages are a direct result of the slow reform of Nepal Oil Corporation. It subsidizes petrol, diesel fuel, and liquefied petroleum gas. The subsidies are partly financed by profits on sales of kerosene and aviation turbine fuel, which are sold above the international price. The prices of subsidized items are being adjusted upward, but there is strong political pressure to maintain high subsidies. The corporation's losses came to NRs11 billion (0.8% of GDP) in FY2011.

The government's decision to recruit a professional managing director for the corporation is a step in the right direction, but wholesale reform, accompanied by complete deregulation of oil prices and legal provisions to allow private service providers in the market, is needed. (Well-directed social protection measures would, of course, be required.) Ultimately, the corporation should cover its own operating costs and make a reasonable return on the government's invested capital.

The country reels under severe power shortages, lasting up to 16 hours a day during the winter months of low hydropower generation, because potential demand is twice current supply. Fixing this situation to provide a foundation for exploiting the country's vast water resources for power generation will be difficult as it requires huge public expenditure as well as public–private partnerships for financing. The first step is to reform Nepal Electricity Authority, allowing it to set tariffs that would induce investment and to tackle its arrears and power theft, without undue political friction.

The current reform of Agriculture Development Bank, which was originally fully owned by the government, lends credence to the view that well-sequenced reforms of human resources, information technology, and commercialization can turn a poorly performing institution into a financially viable entity without impairing its development mission. Nepal has 36 public enterprises, and 11 of them incurred heavy losses in FY2011. Many—particularly the ones with many employees, such as the Nepal Water Supply Corporation—have losses greater than their assets, reflecting the urgent need for public enterprise reform.

3.19.2 The most problematic factors for doing business (% of responses)

Government instability/coups	21.8
Inefficient government bureaucracy	11.8
Policy instability	10.4
Corruption	10.0
Inadequate supply of infrastructure	8.6
Restrictive labor regulations	8.1
Access to financing	7.7
Poor work ethic in national labor force	7.2
Inadequately educated workforce	3.4
Inflation	3.4
Tax regulations	2.5
Crime and theft	2.3
Foreign currency regulations	1.1
Tax rates	1.1
Poor public health	0.6

Note: From a list of 15 factors, respondents were asked to select the five most problematic factors for doing business in their country and to rank them between 1 (most problematic) and 5.

Source: World Economic Forum. 2011. The Global Competitiveness Report 2011-2012. http://www.weforum.org/issues/global-competitiveness